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Malaysia's Unfulfilled Promise: The New Economic Policy in Arrears

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An Intelligence Assessment

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This paper was prepared by [redacted]
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**Malaysia's Unfulfilled Promise:
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Key Judgments

*Information available
as of 10 September 1985
was used in this report.*

As its 1990 target for completion approaches, Prime Minister Mahathir faces a major policy decision on the future of the New Economic Policy (NEP)—the cornerstone of Malaysian economic policy and main buffer against communal tensions since 1971. The NEP has succeeded in giving Malays a larger share in the country's wealth and has eased tensions between Malays and ethnic Chinese. Advancement toward its final goals of economic equity has slowed since 1980, however, because of Malaysia's weakened economic performance, making it unlikely, in our judgment, that the 1990 deadline will be met.

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An unfulfilled NEP will almost certainly damage the prestige of the Malay leadership, especially Mahathir—if he is still in office—because his idea of an affirmative action program for the Malays is the philosophical underpinning of the NEP. As time begins to run out, we believe Mahathir has three options:

- Extend the NEP by continuing its policies and programs under the country's next five-year economic development plan.
- Let the NEP expire and suspend the preferential treatment policies for the Malays, focusing instead on helping them maintain the approximately 20-percent equity share of corporate wealth they have achieved so far.
- Go for broke by undertaking a massive spending effort in the remaining five years in an attempt to achieve the NEP agenda on schedule even though this risks damaging Malaysia's good international credit rating.

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We believe Mahathir's most likely course of action will be to extend the NEP until 1995. This would placate the Malay community by continuing policies beneficial to them and, in our judgment, create only minimal opposition among the Chinese—who accept the NEP as necessary for maintaining national stability. Nonetheless, we believe the perception of the Malay leadership as a symbol of a new prosperous class of well-educated urban Malays—with whom Mahathir is closely identified—could reduce its appeal to the rural Malays, weakening the government's traditional grassroots support in favor of the fundamentalist Islamic party and heightening pressure for stricter Islamic adherence.

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Over the longer term we believe that Mahathir, if he is still in office, would be inclined to let the formal NEP program expire, instead emphasizing his own "Look East" policy through which he seeks to inculcate the Japanese and South Korean work ethic into the Malays in an effort to wean them from the welfare mentality the NEP has generated. We are confident, however, that pressure from within his own party and from the Malay community would result in a continuation of NEP policies in some form.

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The Push for Parity

Since 1971, Malaysian economic policy has been governed by the New Economic Policy (NEP), an ambitious social restructuring program directed at creating economic balance among the country's main ethnic groups, the Malays and the ethnic Chinese. The Malays have held political power since independence in 1957, but the Chinese, along with foreign interests, have dominated the economy. Chinese economic supremacy is a sensitive issue for the Malays because of the unique position the Malaysian Chinese occupy among the Chinese minorities throughout Southeast Asia. Only in Malaysia do the Chinese, along with other immigrant groups, possess sufficient numbers to challenge the political dominance of the indigenous population. Malay perceptions of a potential challenge to their political authority gave rise to the NEP—a framework of policies designed to weaken Chinese dominance of the economy.¹

Declining economic growth has slowed the NEP's progress in recent years and makes it likely, in our judgment, that the NEP's goals will not be met by the 1990 deadline. This shortfall would be particularly harmful if Prime Minister Mahathir is still in office, because his concept of affirmative action for Malays is the philosophical underpinning of the NEP. Ironically, Mahathir—once considered a Malay chauvinist—could become the scapegoat for the NEP's failure to deliver.²

A Good Start . . .

By its midpoint in 1980, the NEP had made impressive strides in achieving greater economic balance largely because a buoyant economy, growing at an annual rate of 8 percent through the 1970s, provided

the government with money to support this restructuring. Government expenditures—financed by trade revenues and oil exports—rose nearly 20 percent annually during the 1970s and funded increases in numerous NEP-oriented programs. Kuala Lumpur used a large portion of this spending increase to acquire equity capital for the Malay community for establishing a commercial and industrial base. Large investments in rural development programs to benefit the Malays were also made.

Although its impact on the rural Malay was modest, according to the US Embassy, the NEP created the first signs of a Malay middle class in towns and cities. Strong economic growth generated an unprecedented 4.1-percent annual increase in employment during the 1970s, helping the Malays make substantial gains in employment in manufacturing and service industries. This transition of large numbers of Malays into the nonagricultural work force in turn boosted Malay mean income at an annual rate of more than 6 percent, contributing to a major decline in poverty during the 1970s. By 1980, the incidence of poverty fell to 29 percent from a level of nearly 50 percent in 1970, according to government data. In the corporate sector, the Malays gained control of 12.5 percent of total equity—an impressive increase from the 2.4 percent they held in 1970.

. . . Slackens

The global recession dampened Malaysia's economy in the early 1980s, slowing economic growth to just over 6 percent annually through 1984. Growth in 1985 is expected to ease to between 5 and 5.5 percent, according to the US Embassy. Depressed international commodity prices—especially for oil, tin, and rubber—substantially reduced both export earnings and the government's trade-based revenues. By 1982 the country's external finances had deteriorated so much that the current account deficit (which measures the balance of trade in goods and services) rose

¹ In the federal elections of 1969, non-Malay opposition parties, championing their own interests, were more successful than expected. With tensions and uncertainty high, racial rioting erupted in Kuala Lumpur three days after the elections.

² Mahathir authored *The Malay Dilemma* in 1970, which, among other things, advocated a constructive "protectionism" for the Malays to enable them to make economic gains against the industrious Chinese.

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The New Economic Policy

In the late 1960s, Malay frustrations over their continuing economic inferiority to the Chinese increased as government pledges for greater Malay participation in the modern sectors of the economy remained unfulfilled a decade after independence. These frustrations, combined with a stonger-than-expected election outcome for non-Malay opposition parties in the 1969 national polls, led to violent racial rioting between Malaysia's main ethnic groups—the Malays who constitute 50 percent of the population and the Chinese who account for 35 percent.

To redress the economic factors that Kuala Lumpur perceived had been at the root of the unrest, in 1971 the NEP was unveiled. Set for 20 years, its objectives were to eradicate poverty and restructure employment and corporate equity in favor of the economically backward Malays. In many respects these goals were considered interdependent and mutually reinforcing because measures to raise incomes in rural areas, where the Malays predominate, would not only reduce poverty but also help correct racial economic imbalance. Similarly, programs to correct racial imbalance by increasing Malay participation in modern activities would also contribute to decreasing poverty by generating increased employment opportunities.

It is the ambitious social restructuring objectives of the NEP, however, that are the focal point of the NEP. This restructuring essentially calls for the transfer of Malays into modern rural and urban activities at all levels of employment—labor and

management—and ownership. In order to achieve the NEP-stipulated shifts in the economic roles traditionally held by the various ethnic groups, Kuala Lumpur at the outset decided to use the public sector as a proxy for the capital-short Malay community. In this role the government has provided direct employment for a large number of Malays by establishing commercial and industrial enterprises. For example, the Food Industries of Malaysia—established in 1972 to promote Malay participation in food-processing industries—employs a work force that is more than 85 percent Malay. Kuala Lumpur also maintains quotas for government work and supply contracts that give Malays preferential treatment in the issuance of licenses. As a result, the number of Malay-owned businesses increased more than three-fold between 1970 and 1980. Kuala Lumpur also acquires corporate equity in trust for subsequent sale in the form of unit shares to the Malay community.

To minimize non-Malay resistance to this pro-Malay policy, the goals of the NEP are not pursued through outright redistribution but as an outgrowth of a rapidly expanding economy. On paper at least, Malay economic advancement occurs as the Malays are granted the lion's share of the opportunities in employment and ownership generated by economic growth. This preferential treatment for the Malays lowers the share of non-Malay holdings relative to the Malays, but the absolute size of their wealth does not necessarily decline.

to \$3.4 billion—nearly 16 percent of GNP—a drastic downturn from a surplus of nearly \$1 billion just three years earlier.

Mahathir's first reaction to these financial strains was to boost foreign borrowing in an attempt to maintain development and social expenditures and to keep up the pace of the NEP's progress. As a result, Malaysia—which entered the 1980s with one of the smallest foreign debts in Asia—turned into one of the

most aggressive foreign borrowers among developing countries, doubling its foreign debt between 1979 and 1982 to \$12 billion.

Despite expansionary government spending, the NEP's performance began to slip because economic growth remained below the 7.8-percent average annual rate that government officials said was necessary to

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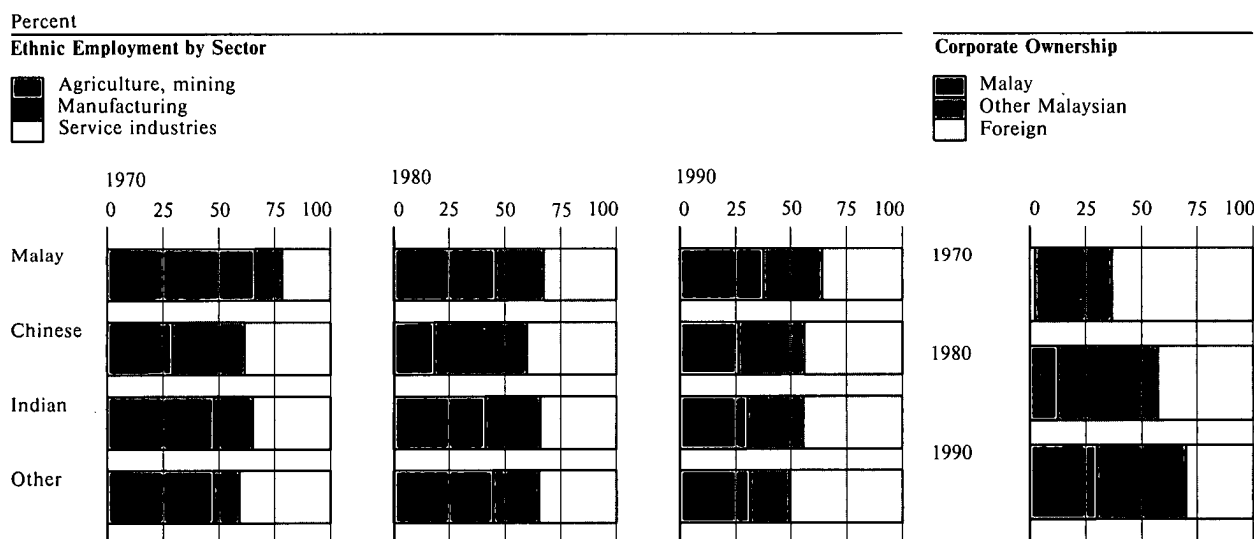
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Figure 1
Malaysia: The NEP Scorecard, 1970-90



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keep it on track. Corporate ownership by Malay individuals, for example, lagged government expectations. Although Malays had acquired almost 19 percent of total corporate equity by 1983, 60 percent of this share was held in government trust agencies. The downward trend in the incidence of poverty was also reversed, as the number of households in poverty increased to more than 30 percent by the end of 1983.

Austerity and the NEP Clash

Confronted with rapidly rising federal budget deficits in the early 1980s, Mahathir has reversed the upward trend in government spending and implemented a program of fiscal austerity. Budgetary cutbacks adversely affected the plethora of government-owned entities established under the NEP, many of which operated at low efficiency by giving priority to NEP goals and not profits. By 1983 more than 80 of these state- and federally-owned companies were shut down.

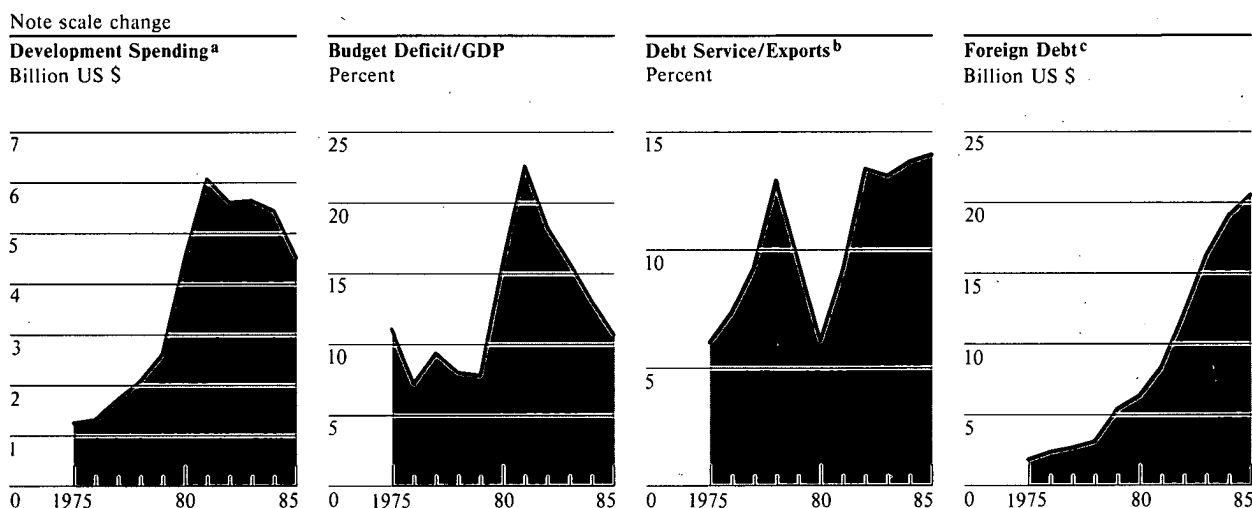
Characteristically, Mahathir took the offensive in defending his actions, chiding the "welfare mentality" of the Malays. Mahathir also introduced other, more radical policies as a longer term strategy for easing budget deficits and foreign borrowing strains. Because these policies alter the established NEP framework, easing non-Malay strictures in ownership and employment, they have been controversial.

Privatization. The proposed sale of selected government enterprises to the private sector is designed to reduce the government's financial burden and to stimulate private investment, according to the government. Mahathir's ambitious privatization agenda, however, is certain to conflict with the NEP goals for increased Malay participation in the economy as the capital-short Malays, unlike Chinese and foreign interests, are financially unable to purchase a substantial share of these newly privatized enterprises. Moreover, as a result of budgetary cutbacks, Malay trust

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Figure 2
Malaysia: Development Spending and Debt, 1975-85



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agencies will also be constrained from large-scale participation in these privatization projects that include major enterprises such as the national airline, telecommunications, and port facilities.

Foreign Equity Revisions. Last July, Kuala Lumpur announced changes in the NEP-established foreign equity regulations with the aim of encouraging more foreign investment. The new rules link the level of equity a foreign partner can hold in a Malaysian venture—previously limited to 30 percent—with the export level of the project.³ Thus, if an enterprise is totally export oriented, full foreign ownership is permitted. Furthermore, the government has given high priority to high-technology ventures, allowing 51-percent foreign ownership regardless of their export orientation. These more lenient equity guidelines will allow more foreign investors to maintain a controlling

³ Activities involving nonrenewable natural resources are exempt from these changes. In these ventures, foreign investment will continue to be limited to 30 percent.

interest in their firms, but at the risk of crowding out potential Malay participants and reversing the NEP trend of less foreign participation in the economy.

Amending the Industrial Coordination Act. Kuala Lumpur has also announced a reexamination of one of the cornerstones of the NEP—the Industrial Coordination Act (ICA), which regulates the development of the manufacturing sector. Under the ICA, the Ministry of Trade and Industry is empowered to impose NEP-oriented conditions on firms that employ more than 25 persons and exceed \$100,000 in capital. These conditions include equity and employment structure, location, and the use of Malay distributors. A recent World Bank/United Nations study, however, proposed that Malay representation in both employment and equity participation would be best accomplished through financial incentives. If Mahathir decides to relax the employment and equity quotas imposed

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Problems Along the Way

The NEP has provided opportunities for some Malays to turn the government's policies to their own advantage, and, in doing so, circumvent the NEP's objectives. This has occurred through the establishment of so-called Ali Baba companies that misrepresent Malay participation. Ali Baba companies are primarily Chinese-owned enterprises that pay Malays a fee for the use of their names on the board of directors or ownership roster in order to appear to be in compliance with the NEP guidelines of 30-percent Malay participation. In many instances, this "Malay representation" is instrumental in the government's approval of licenses, which are granted in favor of Malays.

A similar problem also has occurred in the sale of shares to Malays from the trust schemes operated by the government. These shares are usually sold to Malays below the market price and in many cases were being resold by the Malays for a quick profit. According to government officials, in many instances, Chinese businessmen were financing the purchase of these shares, then selling them and splitting the profit with the "Malay investor." To close this loophole, in 1978 the government established an agency to repurchase Malay-held shares. The repurchase of shares must be made by this agency, effectively ending the leakage of Malay-owned shares into non-Malay hands.

Over the years a major criticism leveled against the NEP has been its tendency to create a select group of Malay millionaires. A minority of Malays who were

already well off have been able to capitalize on the advantages offered by the NEP. In response to this criticism, Kuala Lumpur emphasizes the existence of a trickle-down effect, whereby these enriched individuals in turn benefit the remainder of the Malay community through the establishment of Malay-owned and -operated enterprises. Moreover, according to the government, these millionaires are now able to operate in what was formerly an exclusively non-Malay circle of influential businessmen, thus influencing policies in the business community beneficial to Malays.

In recent years, a major financial scandal involving Bank Bumiputra, an institution founded expressly to help the Malays, has tarnished the NEP's image. The bank's Hong Kong subsidiary was involved in questionable operations resulting in a loss of \$1 billion following the collapse in 1981-82 of a speculative boom in real estate in Hong Kong. The poor management and judgment exercised in handling the Bank's financial affairs reflected poorly on the Malay business community. The huge financial loss also strained the Bank's resources, and the government in mid-1984 announced the takeover of Bank Bumiputra by cash-rich Petronas, the national oil company. This scandal has also had serious political repercussions for the Malay leadership as potentially incriminating disclosures against Mahathir and his administration have surfaced in connection with the financial loss.

under the ICA and in effect weaken the NEP guidelines, we believe substantial opposition would occur within the Malay community and among organized labor.

Mahathir's Dilemma

Despite the need for fiscal restraint and increased private investment, we believe the recent policy changes enacted by the Mahathir government—as

well as the planned revamping of the ICA—puts its popularity at risk among the Malays, who could view these changes as undermining the central thrust of the NEP. Nonetheless, many Malaysian economists believe Kuala Lumpur must take this risk to encourage private-sector growth and help redress the country's balance-of-payments strains.

At the same time, we believe these alterations in the framework of the NEP indicate a fundamental shift in Mahathir's attitude toward the NEP. He deplores the "welfare mentality" the NEP has generated within the Malay community and has privately expressed disappointment with the failure of the Malays to exploit the opportunities available to them under the NEP. According to the US Embassy, Mahathir's contempt for those who think the government is obliged to make them rich is obvious. In our view, his "Look East" policy⁴ is an attempt to counter such attitudes and inculcate a work ethic into the Malay community similar to that of the Japanese, which he believes would make the Malays economically competitive. Over the longer run he believes this will generate a capability for earning and retaining their share of wealth without benefit of further preferential treatment, according to the US Embassy. []

Disillusionment with the outcome of the NEP policy he so strongly advocated represents, in our judgment, a dilemma for Mahathir as he faces a major policy decision concerning the NEP's future. Despite his belief that the Malays themselves are largely responsible for the failure of the NEP to reach its targets, the shortfall will be politically damaging to the Mahathir administration, which has been so closely associated with the policy. In any case, we believe Mahathir will have to choose among three policy options to limit the potentially adverse repercussions stemming from the unfulfilled NEP. []

Extend the Deadline. One possible response is simply to extend the NEP into the Sixth Malaysia Plan (1991-95) by pushing back the target dates and continuing the preferential treatment policies for the Malays.⁵ This is probably the most politically acceptable solution for Mahathir and the rest of the Malay leadership. In addition, we believe this option would create only minimal opposition among the Chinese, who for two decades have been resigned to Kuala

⁴ Introduced in 1982, Mahathir's "Look East" policy promotes the Japanese and South Korean models of development, which stress, among other things, loyalty, diligence, and discipline in the workplace. []

⁵ Since its introduction in the Second Malaysia Plan (1971-75), the NEP has been incorporated as a subset of Malaysia's five-year economic development plans. These plans, as well as their midterm reviews, have provided Kuala Lumpur with ample opportunities to monitor the NEP's progress and institute necessary revisions. []

Lumpur's pro-Malay policy orientation and, according to the US Embassy, accept the NEP as necessary for maintaining national stability. []

On the other hand, we believe it would be less palatable to the Chinese, if, on extending the NEP, Kuala Lumpur imposed additional constraints on non-Malay economic participation. The Chinese are quick to protect their own rights as citizens within the context of the NEP. Concerns, for example, have arisen within the Chinese community over the implementation of privatization, especially with regard to such choice enterprises as the Malaysian Airline System, and Telecoms, the national telephone system. Fearing that they could be barred from participating in such potentially lucrative projects if Kuala Lumpur lopsidedly favors Malays in an effort to boost their lagging progress on corporate ownership, the Associated Chinese Chambers of Commerce and Industry is closely monitoring progress on the privatization agenda. []

For his part, Mahathir is not yet committed to an extension, maintaining that it would be premature at this point because the NEP still has several years to run. On the other hand, since late 1983 Deputy Prime Minister Musa has publicly maintained that the NEP would be continued beyond 1990 until the desired economic balance among the country's ethnic groups is achieved. In response to suggestions from non-Malay politicians that the NEP could be phased out, Musa recently reiterated his commitment to the NEP. He said that efforts to achieve the NEP objectives would continue after 1990, even if they were pursued under a different name. []

Let the NEP Expire. Although it is unlikely, in our view, that the Malay leadership would let the unfulfilled NEP expire, it is an option that cannot be discounted if Mahathir is still in office. In a policy speech given at his party's annual conference last year, Mahathir stressed that an NEP extension was not the key for solving the economic backwardness of the Malays. According to the US Embassy, Mahathir

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A Continuing Shift Toward Islamic Accommodation

Although Islam traditionally has been an essential element of Malay ethnic identity, in recent years there has been an upsurge of Islamic sentiment and practice across the spectrum of Malay society. The Mahathir government, according to the US Embassy, has sought to shape this Islamic revival rather than to slow it. Mahathir has co-opted some of the Islamic opposition's demands for stricter observance of dress, diet, and worship tenets, and the promotion of traditional Islamic lifestyles and scholarly studies. The consequent appearance of increasing Islamic practices—further enhanced by Mahathir's co-option of a prominent Islamic youth leader into the United Malays National Organization—has helped the government defuse further demands for fundamentalist changes while permitting continued official promotion of a multiracial secular society in which Malays and Chinese can coexist and prosper.

We believe the success of the NEP in creating a new Malay middle class, however, is increasing the demands for greater Islamic adherence. Uncomfortable with the rush to materialism and Western values, according to the US Embassy, newly prosperous Malays have renewed their commitment to Islam in an attempt to legitimize their new identity. Moreover, pressure for increased Islamization is also being felt from the rural Malays who have become increasingly disillusioned with the less traditional Islam touted by the government. Consequently, to counter the threat of a large-scale shift in allegiance to the opposition Islamic fundamentalist party, we believe the Malay leadership will continue to be required to prove its Muslim credentials through increased rhetoric and concessions.

is much less content than his predecessors with the mechanical accumulation of percentages of Malay ownership in quasi-governmental companies. Whatever Mahathir and the Malay leadership decide about this option, we believe the prospects for its adoption would increase in the event of a drastic downturn in the international economy during the next few years that would intensify the financial strains Kuala Lumpur is already experiencing.

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If the NEP were permitted to expire, however, we believe some of its policies and programs would be continued under another guise. This would allow Mahathir to excise large portions of the NEP and ease the government's financial burden while leaving in place certain structural aspects—such as university quotas for Malay students and preferential treatment in awarding government contracts for Malays—which enterprising Malays could exploit. Although not as comprehensive as the original NEP, such a new policy, in our view, would accord more closely with Mahathir's views of offering opportunities and not a free ride to the Malays. Moreover, we believe many in the Malay community would accept this decision, although some more grudgingly than others, because the government would continue to be at least partially liable for their economic advancement after the NEP had run its course.

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Go For Broke. Finally, the Mahathir government could attempt to achieve the NEP agenda on schedule by introducing a "go for broke" strategy in the soon-to-be-released Fifth Malaysia Plan for 1986-90. Such an effort would require massive government financing, thus exacerbating budget deficits and accelerating foreign borrowing. The financial effort, in our view, would probably undermine Malaysia's good international credit standing and run the risk of leaving its external accounts vulnerable in the event of an international economic downturn. It would, moreover, be in direct conflict with Mahathir's austerity policies of the past three years, and we believe it is the unlikeliest of the three options.

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Looking Ahead

In the short term, we believe Mahathir will probably choose to continue the NEP in the post-1990 period. Facing reelection within the next two years, he will need to appear aligned with the equity goals of the NEP in order to maintain political support, especially within his party, which represents the majority of Malays. Although we believe Mahathir would prefer to call elections as soon as possible to maintain, among other things, some distance from the failed NEP targets, he is currently constrained by other political factors.⁶ [REDACTED]

In the longer term, if the NEP is extended beyond 1990, we believe its role in Malaysian economic and social policy will diminish. Mahathir's efforts to wean the Malays slowly away from the "handout mentality" probably will result in a further weakening of the NEP's policies, similar to the revisions announced this year in the foreign equity guidelines. We believe the pace of this weakening will be largely dictated by international economic conditions. Continued financial strains would make it easier for the government to argue that a further scaling-down of the NEP's programs and policies is necessary, permitting an aggressive phasing out of the NEP. [REDACTED]

Potential New Wrinkles

A diminished role for the NEP could provoke new communal tensions, in our judgment. The emergence of a Malay middle class under the NEP has brought many Malays into the economic mainstream, but, according to the US Embassy, many more have been left behind. This division within the Malay community alters the longstanding adversarial role held by the Chinese community in Malaysia as the Malays left behind press for preferential treatment to compete against other Malay as well as Chinese economic

⁶ The chief obstacle to early elections remains the disarray in the Malaysian Chinese Association (MCA), the second-largest partner in the National Front coalition, which Mahathir's United Malays National Organization (UMNO) leads. Before Mahathir can call general elections, a contentious leadership issue must be resolved in the MCA and party divisional elections must be held. In a mid-August meeting of the ruling coalition's supreme council, the MCA was given three months to resolve its crisis. If the leadership issue is not resolved by that time, the MCA will be expelled from the coalition [REDACTED]

interests. Moreover, with the current Malay leadership more closely identified with the new class of urban, well-educated Malays, we believe rural Malays probably would seek a political voice more closely aligned with their own interests. Such a realignment could reduce the traditionally strong grassroots support for the Malay leadership and strengthen the attraction of its main—but thus far ineffective—rival for the Malay vote, the fundamentalist Islamic party. [REDACTED]

It is also possible, in our judgment, that a diminished NEP would create a social and cultural vacuum for the Malay community, which might be filled by a heightened Islamic adherence. Although the NEP is largely an economic affirmative action program, it also helps to preserve and promulgate the Malay—that is, Muslim—identity. As matters now stand under the NEP, the Malay community believes two important aspects of their culture—Islam and the national language—are receiving the status they deserve. Under a watered-down version of the NEP, however, Malay perceptions of increasing cosmopolitan influences within Malaysian society might precipitate calls—from both the new prosperous urban Malays and the more traditional rural Malays—for stricter adherence to Islamic principles. [REDACTED]

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